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John H. Biggs
Chairman, President and Chief Executive Officer
TIAA-CREF

TIAA-CREF is the largest private pension system in the world, providing pensions and other financial products to the education and research community. We manage about $275 billion in assets through TIAA, a New York licensed stock life insurance company, and CREF, the country's first variable annuity plan. We also offer to the general public life insurance products, trust services, mutual funds, and college tuition savings plans.

In addition to my role as Chairman, President and Chief Executive Officer of TIAA-CREF, my other experience relevant to your deliberations is as an independent public sector participant in financial regulation. I served for two years as a Governor of the NASD and some five years as a Trustee of the Financial Accounting Foundation, which funds the Financial Accounting Standards Board, or FASB, and appoints its members. I now serve as a Trustee of the Foundation supporting in a similar way the new International Accounting Standards Board (IASB). I was also a member of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees. I served as one of the five trustees, all of us independent, of the Public Oversight Board, which went out of business on March 31, 2002. I presently serve on the Board of the Boeing Corporation. I am not an accountant but did start my career as an actuary and earned a Ph.D. in economics along the way.

I believe that all types of employee stock options should be expensed in income statements. Shares of stock given to employees are required to be expensed. Options given to nonemployees must be expensed. The current accounting rules, written in 1972, requiring an expense charge for performance options, but zero expense charge for fixed options given to employees, make no sense. In this statement, I describe in detail the problems with current accounting requirements, the perverse incentives created by these accounting requirements, international efforts to change accounting rules, and various related issues including shareholder approval of option plans, academic research, and option repricing.

TIAA-CREF has been active in the corporate governance arena for about 15 years, and we continue to be active on many issues. We believe board independence and independent key committees are essential for good corporate governance. We closely follow executive compensation practices at our portfolio companies. One of our significant issues this year is shareholder vote reform for all material option plans. However, good financial reporting is a key ingredient in good corporate governance. The accounting rules for stock options in the U.S. are influencing behavior in ways that are counter to investor interests. A level playing field across all types of options is necessary to bring more rational pay schemes into existence.

There has been a significant amount of press coverage about executive compensation, in particular, the stock option issue, in the last few months. In the post-Enron environment, questions have been raised about whether employee stock options contributed to an atmosphere in which employees were more focused on the stock price than on "doing the right thing." Many have questioned whether the current accounting is a reasonable representation of the actual economic events. From Federal Reserve Chairman Alan Greenspan to President George W. Bush, the accounting issue has been raised. In Appendix A, I include the full texts of recent testimony by Chairman Greenspan and Nobel Laureate Professor Joseph Stiglitz. Also included is a letter to the editor of the New York Times from Stephen Barr, an editor of CFO magazine.

Chairman Greenspan describes what he views are severe market distortions from not showing a significant cost from options in reported financial statements, and he also rejects several critics' arguments against option expensing. Professor Stiglitz discusses misinformation in the markets, and also supports the idea that reasonable estimates of value are available and should be recognized as expense. Interestingly, Mr. Barr of CFO magazine looks at the issue from a different angle. He asks what would be different today if the FASB had been successful in the mid-90s and expense treatment for all options had been required. His conclusion is that our economic situation would be exactly the same; however, there might be fewer questions about accounting "gamesmanship."

Overuse and Abuse of Stock Options

There is no question that current accounting rules for options are driving behavior in employee compensation. The current rules that govern option accounting, written in 1972, are absurd. Among other things, those rules allow fixed at-the-money options to be viewed as "free," regardless of how many are issued, even though those options form a central feature of executive compensation plans and obviously have very substantial costs.

Most companies use stock and stock options to pay employees. In the S&P 500, 99% of the companies provide stock options to employees, and only two of those companies show expense for stock options. As a result, earnings in 2000 were overstated by about 12%. Tax benefits, via corporate deductions for compensation, from options averaged nearly $3,000 per employee. Sixty-eight percent of companies had share buyback programs, and they used an average of 48% of net income to reacquire those shares.

The Association for Investment Management and Research (AIMR) published survey results in November 2001 from 1,944 worldwide analysts, in which more than 80% said that employee stock compensation should be required to be shown as expense in earnings.

The tax benefits recognized in 2000 were enormous, with technology companies in the S&P 500 showing an average tax benefit of $234 million. The IRS allows as a deduction for compensation expense the difference between the option price and the stock's price when it is exercised (for most employee stock options). But in reports to shareholders that difference, or any other amount, is never shown as an expense. The Levin-McCain-Fitzgerald-Durbin-Dayton bill, "Ending the Double Standard for Stock Options Act," S. 1940, would call for limiting the tax deductions to the amount shown in financial statements as option expense. For all but a handful of companies, the bill would have a tremendous effect, presumably on reported earnings.

We support the objectives of that bill—to end the fiction that options have no cost for GAAP financial statement purposes. We agree that expense for options should be shown on income statements, particularly when large tax deductions are taken for compensation expense from employee options. It simply isn't credible for companies to say that no reasonable estimate of value for employee options is possible for income statements, when those same companies recognize large option expense amounts for tax purposes. TIAA-CREF would like to see financial reporting improved in a direct way—via changes to the accounting rules—rather than amendments to the tax code. The U.S. tax code has built into it all sorts of incentives, and those incentives result in differences between GAAP reporting and tax reporting, not necessarily a bad result. The current taxation rules generally result in individual income tax on the realized gain. For the most part, that same amount is the deductible expense for the company. Although the legislation has a certain appeal, resulting in symmetry between tax and financial reporting for option expense, we would prefer to address the financial reporting deficiency directly.

FASB Efforts

Through its long and open process the FASB explored all theoretical aspects of stock options during the late 1980s and early 1990s. It put out tentative proposals, conducted exhaustive hearings so that all participants could comment, and heard arguments pro and con. The process took several years.

Many critics now say the FASB is too slow, but at other times critics have said it was too fast, especially when the issue was an unpopular one such as stock compensation or derivatives. The original 1993 proposal would have required a charge to expense for stock options given to employees as compensation. After extensive lobbying of Congress by companies and auditing firms, and following legislative threats to the existence of private sector standard setting, the FASB and the SEC capitulated. Arthur Levitt has publicly stated that he believes this was the greatest mistake made by the SEC during his chairmanship.

In capitulating, the FASB published a rule in 1995, known as Financial Accounting Standard 123, *Accounting for Stock-based Compensation*, that offers the choice of expense recognition <u>or</u> disclosure in footnotes. Expense recognition is stated as the preferred method, but only a few companies have adopted the expense alternative. If disclosure is chosen, the income statement will show expense for options only under certain circumstances required by the Accounting Principles Board (the predecessor to the FASB) in its Opinion No. 25 (1972). Opinion 25 requires expense for most performance options, and any other award that is considered "variable" under its terms. If all of the option award's characteristics are fixed at the date of grant, expense is measured as the difference between the exercise price and the market price of the stock. Although a few options are granted above or below current market prices, the vast majority of options are granted "at-the-money," resulting in a zero expense.

Variable awards, such as indexed options, result in expenses that change as market prices change until the options are exercised. Indexed options tie the employee exercise price to a market or peer index, generally meaning that the company's stock price must outperform an index before the options are exercisable. Those types of options can work in both increasing and decreasing markets. Compensation is paid if the company's performance is better than peers, even if "performance" is a lesser decrease than other companies in the index. We would be very happy if more companies adopted performance based option plans. In down markets, repricings would not be necessary if indexed options were used. However, most corporations want to avoid uncertainty and volatility in earnings, and therefore reject performance-based options. The 1972 accounting rule is discouraging the use of performance awards. Significantly, most companies use virtually no other form of stock award than the fixed at-the-money option, which is treated as "free" under obsolete accounting rules.

The FASB said the following in Statement 123, with which I completely agree: "The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue—not because it believes that solution is the best way to improve financial accounting and reporting." (Paragraph 62) In other words, disclosure in footnotes is inappropriate reporting to shareholders of the costs of operations.

As you might expect, most corporations prefer to use the obsolete 1972 accounting model, which treats the fixed price stock option as “free” and treats performance options as potentially very expensive. Companies are required to disclose in a footnote what the cost would have been, and show the pro forma net income and earnings per share, if an expense charge for options had been recognized. Statement 123 calls for a fair value measure at the date of grant. The Black-Scholes option-pricing model, with adjustments for the differences between employee options and traded options, is the basis for the measurement.

Note that the Black-Scholes option-pricing model was created in 1973, one year after the APB issued Opinion 25. That seminal work forms the basis for understanding a myriad of financial transactions involving uncertainty. I can assure you that company executives and compensation consultants routinely use the Black-Scholes model to value employee options. Most companies also use Black-Scholes to communicate total compensation to employees. Those same executives know that having to show the results of that calculation to shareholders would reduce or in some cases eliminate the earnings of their companies.

I serve as a Director of the Boeing Company, which is one of the few major U. S. companies to adopt Statement 123 expense, in order to report to its shareholders the true cost of its stock compensation plan. Boeing’s executive compensation plan is based heavily on tough performance tests that are prohibitively expensive under the 1972 accounting model used by all other companies. For the record, Boeing adopted its plan and Statement 123 in 1996, before I became a director.

I might mention a further example of the strong-arm tactics of U. S. corporations. Last year the Financial Executives International issued a press release threatening to withdraw funding for the newly formed International Accounting Standards Board if the Board dared to study the issue of accounting for stock-based compensation. At that time, both the FEI and the National Venture Capital Association wrote letters to SEC Chairman Harvey Pitt asking the Chairman to focus on the issue, describing what they view as negative consequences of accounting standards.

The use of options and stock as employee compensation is a growing phenomenon overseas, with little or no accounting guidance in place. In international literature, there is scant attention paid to transactions paid for in stock, let alone stock options. It is possible to pay expenses to outsiders with stock and show zero expense, which surely is an area that must be addressed. I am happy to say that both Paul Volcker, Chairman of the Foundation supporting the IASB, and Sir David Tweedie, Chairman of the IASB, are standing their ground, and the project is proceeding. An Exposure Draft is expected by the end of 2002, and the IASB has been deliberatively studying the issues raised in a discussion paper issued in 2000 by the previous International Board and other standard setters, commonly known as the G4+1.

Diluted Earnings Per Share is Not a Solution

Diluted earnings per share cannot and does not measure the cost of employee stock options. Diluted earnings per share is a measure of earnings that is required to be shown by FASB Statement No. 128, *Earnings per Share*. It requires that a performance measure be shown in two ways—basic earnings (net income from the income statement) per share and diluted earnings per share. The following is a general, simplified summary of the accounting for earnings per share. The diluted earnings per share measure starts with the same net income amount as basic earnings per share for the numerator. However, the number of shares used in the denominator for diluted earnings per share is changed to show the "pro forma" effect of a number of items, including convertible debt, written put options, forward purchase contracts, warrants, and stock options. The number of shares to use for diluted earnings per share must include only those instruments that would be dilutive. For example, only options that are "in-the-money" are included, not all outstanding options.

An example illustrates how the current accounting for earnings per share is done. If a company gives an employee a share of stock, not an option, the company must show two effects—both the cost of the share and the increase in outstanding shares. That share issuance is reflected in net income as a cost, and the earnings per share measure would use an increased number of shares. A similar accounting result occurs if a company sells options for cash and gives the cash to employees. There is both a cost and an effect on shares outstanding.

For most stock options issued directly to employees, accounting rules do not require that a cost be shown in earnings. The result is that only one part of the option issuance is shown to investors. That dilutive effect on outstanding shares also is shown only if options are "in the money". There clearly is a potential dilutive effect from options that are out-of-the money. The cost of options is not recognized in net income and therefore cannot be reflected in any measure of diluted earnings per share.

Stock options are simply another form of equity that should be treated in the same way as shares of stock. When diluted earnings per share is proposed as a solution for stock option accounting, it simply is a smokescreen. The two accounting measures are like apples and oranges and should not be linked. Both are important measures to investors. However, the real issue is that there should be a cost for employee stock options in earnings.

Post FASB Statement 123 Activity

The use of questionable accounting methods for stock options has had several negative results:

(1) **Explosive growth in the use of stock options since 1995—huge, indeed, incredible awards to CEOs and in some companies awards to every employee.** For several years, the increasing number of issued options has been a major concern addressed by TIAA-CREF's corporate governance program. We vote at all of our portfolio companies, using guidelines, including "red flags" for large potential dilution from stock option programs. At some companies, options outstanding or available for grant exceed 40% of the total shares outstanding. At those companies, we are voting against option plans, and we expect to continue to do so. See later discussion about the right of shareholders to vote on material option plans.

(2) **The serious distortion of earnings statements so that some companies report large earnings at the same time that no taxes are paid.** This is because of peculiar accounting that results in fixed price stock options as zero "cost" in public income statements while allowing the employee gain from most options to be shown as a "cost" for the tax return. Tax deductions and the option program itself are sources of cash flow for companies, some to such an extent that cash flow from option exercises exceeded cash flow from operations in 2000.

(3) **Unprecedented focus on the stock price by all the employees of the company, to the point where serious ethical dilemmas are posed for employees.** When excessive stress is placed on company accountants and their auditors, malfeasance may result. Business ethics experts wonder if potential "whistle blowers" are intimidated by their colleagues or their own concern for their stock options.

(4) **The dramatic decline in dividends is a direct result of so much recent attention to stock options.** A dollar per share paid to a shareholder as a dividend reduces the stock price by a dollar. Can anyone wonder why corporate managers find many reasons to justify a reduction or elimination of the dividend?

(5) **In many companies, stock options have replaced pension plans entirely.** When we protested the action of IBM in abandoning its

defined benefit plan, the company responded by pointing out that its competitors in the technology world had no pensions whatsoever.

(6) **There has been an almost exclusive use of the "fixed-price" stock option in employee compensation plans.** More desirable stock compensation plans could be devised that would better align management and shareholder interests. Plans such as performance options or indexed options are effectively prohibited by the 1972 rules because they require that management show an expense for them. FASB Statement 123 provides sensible expense accounting for performance plans, and provides similar accounting for options issued to employees and nonemployees alike.

(7) **The recent downturn in the market has resulted in option repricings, in which employees exercise prices are reduced to reflect market price declines.** The majority of recent repricings have been effected using the "6-and-1" approach, avoiding any accounting expense for the repricing. See the section titled, "Repricings" that follows for a complete description of the issue and the problem.

Need for Shareholder Approval

Until recently, shareholders had little disclosure of how many options were being authorized. New SEC requirements will be in effect next year calling for disclosure of options, with separate disclosure of option plans approved by shareholders and options not approved by shareholders. We applaud the SEC for implementing new disclosure rules. However, we are concerned that under "broad-based" exceptions to stock exchange shareholder approval requirements, increasing numbers of boards have implemented stock option plans without seeking shareholder approval. The SEC estimates that 20% of publicly traded companies with equity compensation plans have plans that have not been approved by shareholders. In the technology environment, compensation consultants estimate that approximately 30% of companies have option plans that were not approved by shareholders.

TIAA-CREF and other institutional investors for several years have encouraged the New York Stock Exchange and NASDAQ to strengthen shareholder-voting requirements. The NYSE established a task force in 1999 that articulated a reasonable compromise on this issue, but the NYSE had been unwilling to implement the proposal unless NASDAQ adopts a similar standard. (More recently, the NYSE has said that it may move forward on elements of the proposals without NASDAQ.)

The NYSE task force compromise would require shareholder approval of any plan for which directors and/or executives are eligible, and would limit the amount of potential dilution from plans that have not been approved by shareholders to 10% of the equity compensation plan shares that have been approved by shareowners. To date, NASDAQ has declined to accept this dilution standard, though NASDAQ appears willing to accept the voting requirement for plans for executives and directors. SEC Chairman Harvey Pitt has urged the exchanges to take action, and we are hopeful that NASDAQ may soon move forward on this issue. TIAA-CREF has had discussions with several companies regarding option plan approval policies. Those companies targeted for discussion maintain significant stock option plans that have not been approved by shareholders. Option grants under these plans, most of which have been in place for only a few years or less, run up to 40% of shares outstanding.

We believe that all material option plans should be put to vote of shareholders, regardless of the option recipients. These option plans materially dilute our ownership interest and the shareholder vote is critical.

Repricings

If stock prices decline, companies might want to consider whether options granted in the past are continuing to provide the incentive and the compensation that were intended with the initial grant. If options are significantly "out-of-the-money," they likely do not serve as much of an employee incentive. Many companies reprice employee options to retain and motivate employees. Certainly, employees have the ability to go to work for another employer and receive new options. Accounting treatment for repricings is diverse, depending on the method of repricing. FASB Statement 123 calls for a reasonable approach to repricings. A value-for-value exchange is computed at the date of exchange and any additional value conferred is recognized as expense over any new service period.

Because most companies do not use Statement 123 for expense recognition, the FASB interpreted APB Opinion 25 and issued repricing guidance in 2000, included in FASB Interpretation No 44. If options are repriced in a straightforward way—simply reduce the exercise price of existing options—the original options are considered variable under Opinion 25, resulting in expense. If however, an exchange is organized such that employees return the old options, and the company waits at least 6 months before issuing new at-the-money options, the new award can be considered fixed, resulting in zero expense. Clearly, the 6-month waiting period provides unusual incentives to employees. Investors are concerned that employees would be motivated to lower stock prices during that 6-month period before new options are granted. The "alignment" achieved via the "6-and-1" repricing seems to be alignment with short sellers, not the expected alignment of interests between employees and shareholders.

In a study of 170 repricings in 2001, Institutional Shareholder Services reports that 74% of repricings were effected through the “6-and-1” approach. Seventy-three percent of companies repriced on a share-for-share basis, meaning that the same number of options were exchanged, rather than a value-for-value exchange. Fifty-five percent left the same vesting schedules in place for the new options. Perhaps most disturbing, however, is the fact that 60% of the companies repriced options for officers and/or directors. In earlier repricings, most companies repriced options only for those employees below the executive ranks.

The Opinion 25 interpretation for a “6-and-1” repricing is difficult to understand, except in the context of the 1972 rule on which it is based. If the terms of awards are fixed and issued at-the-money, no expense is recognized. If the award is variable, expense is recognized. This and other ad hoc interpretations of Opinion 25 lead us to conclude that the basic model for employee options is in surely need of reform. Even-handed treatment for slight variations in awards is possible only if the basic model is sound.

Academic and Other Research

In April 2001, the TIAA-CREF Institute, in cooperation with the TIAA-CREF corporate governance staff, sponsored a Corporate Governance Forum, *Executive Compensation, Stock Options, and the Role of the Board of Directors*, at which the issues of executive compensation and the use of stock options were examined and discussed in detail. The forum brought together academics, compensation consultants, corporate officers and directors, corporate human resources personnel, institutional investors, regulators, and other practitioners. Several points about options as incentives were made. For example, stock prices may be a poor measure of employee performance, because stock price changes are beyond the control of most employees. The issue is whether option plans reward employees for superior performance—or for luck.

Academic research suggests that employees place a lower value on stock options than the potential cost of those options. It also was argued that option-based compensation may not be appropriate for employees at lower levels in the corporation because of the risk involved.

Some academic research seems to conclude that current stock prices reflect information reported in footnotes about employee option costs. One research paper says, “ . . . stock-based compensation expense has a negative relation with share price, consistent with investors viewing it as an expense of the firm. This finding calls into question the quality of reported earnings, because without recognition of stock-based compensation expense under SFAS 123, this expense is never included in net income. It also indicates that stock-based compensation expense is measured with sufficient reliability to be reflected in investors' valuation assessments." (*SFAS 123 Stock-Based Compensation Expense and Equity Market Values*, David Aboody, Mary Barth, and Ron Kasznik, 2001) Another research paper seems to say that market prices reflect option costs, but also that option exercises provide additional information to the market. (*Do Stock Prices Incorporate the Potential Dilution of Employee Stock Options?*, Gerald Garvey and Todd Milbourn, 2001)

A complete summary of the April 2001 TIAA-CREF Institute forum can be found on the Institute website at www.tiaa-crefinstitute.org. The following is an excerpt from the summary:

> Two observations suggest that financial accounting considerations may unduly influence compensation policy: first, the continued use of standard at-the-money options relative to potentially superior alternatives such as performance-based options; and second, the gaming of the accounting system, particularly in the case of the synthetic six-month-plus-one-day repricings. The proclivity of companies to adopt compensation policies to avoid a charge to earnings is somewhat disturbing. Indeed, it leads one to question whether a myopic focus on measured earnings and earnings per share distorts economic decisions and results in the adoption of suboptimal compensation programs.

Conclusion

Private sector standard setting has worked well in this country, via the FASB or GASB (the Governmental Accounting Standards Board), and I am supportive of the private sector International Accounting Standards Board. It is untenable for any government to directly set accounting standards. Congress, through the political process, should not enter into technical issues of accounting rules, but it should oversee the system through the SEC and should demand a fair and open process. Some expression of support by your Committee might make it possible for there to be improvements to the required accounting rules. Although expense recognition is stated as the preferred approach by the FASB, unless some action is taken, we are concerned that current indefensible accounting rules for employee stock options will continue.

APPENDIX A

Speech by Federal Reserve Chairman Alan Greenspan
New York University, March 26, 2002:

Some changes, however, appear overdue. In principle, stock-option grants, properly constructed, can be highly effective in aligning corporate officers' incentives with those of shareholders. Regrettably, the current accounting for options has created some perverse effects on the quality of corporate disclosures that, arguably, is further complicating the evaluation of earnings and hence diminishing the effectiveness of published income statements in supporting good corporate governance. The failure to include the value of most stock-option grants as employee compensation and, hence, to subtract them from pretax profits, has increased reported earnings and presumably stock prices. This would be the case even if offsets for expired, unexercised options were made. The Financial Accounting Standards Board proposed to require expensing in the early to middle 1990s but abandoned the proposal in the face of significant political pressure.

The Federal Reserve staff estimates that the substitution of unexpensed option grants for cash compensation added about 2-1/2 percentage points to reported annual growth in earnings of our larger corporations between 1995 and 2000. Many argue that this distortion to reported earnings growth contributed to a misallocation of capital investment, especially in high-tech firms.

If market participants indeed have been misled, that, in itself, should be surprising, for there is little mystery about the effect of stock-option grants on earnings reported to shareholders. Accounting rules require that enough data on option grants be reported in footnotes to corporate financial statements to enable analysts to calculate reasonable estimates of their effect on earnings.

Some have argued that Black-Scholes option pricing, the prevailing means of estimating option expense, is approximate. But so is a good deal of all other earnings estimation, as I indicated earlier. Moreover, every corporation does report an implicit estimate of option expense on its income statement. That number for most, of course, is zero. Are option grants truly without any value?

Critics of option expensing have also argued that expensing will make raising capital more difficult. But expensing is only a bookkeeping transaction. Nothing real is changed in the actual operations or cash flow of the corporation. If investors are dissuaded by lower reported earnings as a result of expensing, it means only that they were less informed than they should have been. Capital employed on the basis of misinformation is likely to be capital misused.

Critics of expensing also argue that the availability of options enables corporations to attract more-productive employees. That may well be true. But option expensing in no way precludes the issuance of options. To be sure, lower reported earnings as a result of expensing could temper stock price increases and thereby exacerbate the effects of share dilution. That, presumably, could inhibit option issuance. But again, that inhibition would be appropriate, because it would reflect the correction of misinformation.

Testimony of Dr. Joseph Stiglitz, Nobel Laureate Professor of Economics, Columbia University
Senate Banking Housing and Urban Affairs Hearing,
"Review of U.S. Economic Health"

Tuesday, March 12, 2002:

At the time I served on the Council of Economic Advisers, we raised strong concerns about conflicts of interest and problems in accounting standards and practices, particularly as they related to derivatives and options. Our concerns have proved to be on the mark. There were others who raised similar concerns. Arthur Levitt, of course, was right in calling attention to the conflicts of interest in the accounting firms, when they simultaneously provide consulting services. FASB called for a changing of accounting practices to more accurately reflect the costs of options given to executives. I strongly agreed. The Secretary of Treasury and the Secretary of Commerce, however, violated basic principles of good governance, which call for the independence of FASB, and intervened to squash the proposed revisions. They succeeded.

I have devoted much of my academic life to the economics of information, and to the consequences of imperfections of information. The proposed revisions would have improved the quality of information. To be sure, some firms' economic prospects might have looked worse as a result, and its stock market price might have fallen as a result--as well it should. It was inevitable that a day of reckoning would come. Providing misleading information only delayed the day of reckoning, but worse, it led to a misallocation of resources, as overinflated stock prices led to the excessive investment which is at the root of the economic downturn.

Some contend that it is difficult to obtain an accurate measure of the value of the options. But this much is clear: zero, the implicit value assigned under current arrangements, is clearly wrong. And leaving it to footnotes, to be sorted out by investors, is not an adequate response, as the Enron case has brought home so clearly. At the Council of Economic Advisers, we devised a formula that represented a far more accurate lower bound estimate of the value of the options than zero. Moreover, many firms use formulae for their own purposes, in valuing stock options (charging them against particular divisions of the firm). However, Treasury, in its opposition to the FASB concerns, was singularly uninterested in these alternatives. I leave it to others to hypothesize why that might have been the case.

If we are to have a stock market in which investors are to have confidence, if we are to have a stock market which avoids the kind of massive misallocation of resources that result when information provided does not accurately report the true condition of firms, we must have accounting and regulatory frameworks that address these issues. As derivatives and other techniques of financial engineering become more common, these problems too will become more pervasive. While headlines and journalistic accounts describe some of the inequities--those who have seen their pensions disappear as corporate executives have stashed away millions for themselves--what is also at stake is the long run well being of our economy. The problems of Enron and Global Crossing are part and parcel of the current downturn.

Warren Buffett, Opinion in the Washington Post
Stock Options and Common Sense
April 9, 2002:

In 1994 seven slim accounting experts, all intelligent and experienced, unanimously decided that stock options granted to a company's employees were a corporate expense. Six fat CPAs, with similar credentials, unanimously declared these grants were no such thing.

Can it really be that girth, rather than intellect, determines one's accounting principles? Yes indeed, in this case. Obesity–of a monetary sort—almost certainly explained the split vote.

The seven proponents of expense recognition were the members of the Financial Accounting Standards Board, who earned $313,000 annually. Their six adversaries were the managing partners of the (then) Big Six accounting firms, who were raking in multiples of the pay received by their public-interest brethren.

In this duel the Big Six were prodded by corporate CEOs, who fought ferociously to bury the huge and growing cost of options, in order to keep their reported earnings artificially high. And in the pre-Enron world of client-influenced accounting, their auditors were only too happy to lend their support.

The members of Congress decided to adjudicate the fight -- who, after all, could be better equipped to evaluate accounting standards? -- and then watched as corporate CEOs and their auditors stormed the Capitol. These forces simply blew away the opposition. By an 88-9 vote, U.S. senators made a number of their largest campaign contributors ecstatic by declaring option grants to be expense-free. Darwin could have foreseen this result: It was survival of the fattest.

The argument, it should be emphasized, was not about the use of options. Companies could then, as now, compensate employees in any manner they wished. They could use cash, cars, trips to Hawaii or options as rewards—whatever they felt would be most effective in motivating employees.

But those other forms of compensation had to be recorded as an expense, whereas options -- which were, and still are, awarded in wildly disproportionate amounts to the top dogs -- simply weren't counted.

The CEOs wanting to keep it that way put forth several arguments. One was that options are hard to value. That is nonsense: I've bought and sold options for 40 years and know their pricing to be highly sophisticated. It's far more problematic to calculate the useful life of machinery, a difficulty that makes the annual depreciation charge merely a guess. No one, however, argues that this imprecision does away with a company's need to record depreciation expense. Likewise, pension expense in corporate America is calculated under wildly varying assumptions, and CPAs regularly allow whatever assumption management picks.

Believe me, CEOs know what their option grants are worth. That's why they fight for them.

It's also argued that options should not lead to a corporate expense being recorded because they do not involve a cash outlay by the company. But neither do grants of restricted stock cause cash to be disbursed—and yet the value of such grants is routinely expensed.

Furthermore, there is a hidden, but very real, cash cost to a company when it issues options. If my company, Berkshire, were to give me a 10-year option on 1,000 shares of A stock at today's market price, it would be compensating me with an asset that has a cash value of at least $20 million -- an amount the company could receive today if it sold a similar option in the marketplace. Giving an employee something that alternatively could be sold for hard cash has the same consequences for a company as giving him cash. Incidentally, the day an employee receives an option, he can engage in various market maneuvers that will deliver him immediate cash, even if the market price of his company's stock is below the option's exercise price.

Finally, those against expensing of options advance what I would call the "useful fairy-tale" argument. They say that because the country needs young, innovative companies, many of which are large issuers of options, it would harm the national interest to call option compensation an expense and thereby penalize the "earnings" of these budding enterprises.

Why, then, require cash compensation to be recorded as an expense given that it, too, penalizes earnings of young, promising companies? Indeed, why not have these companies issue options in place of cash for utility and rent payments—and then pretend that these expenses, as well, don't exist? Berkshire will be happy to receive options in lieu of cash for many of the goods and services that we sell corporate America.

At Berkshire we frequently buy companies that awarded options to their employees—and then we do away with the option program. When such a company is negotiating a sale to us, its management rightly expects us to proffer a new performance-based cash program to substitute for the option compensation being lost. These managers—and we—have no trouble calculating the cost to the company of the vanishing program. And in making the substitution, of course, we take on a substantial expense, even though the company that was acquired had never recorded a cost for its option program.

Companies tell their shareholders that options do more to attract, retain and motivate employees than does cash. I believe that's often true. These companies should keep issuing options. But they also should account for this expense just like any other.

A number of senators, led by Carl Levin and John McCain, are now revisiting the subject of properly accounting for options. They believe that American businesses, large or small, can stand honest reporting, and that after Enron-Andersen, no less will do.

I think it is normally unwise for Congress to meddle with accounting standards. In this case, though, Congress fathered an improper standard—and I cheer its return to the crime scene.

This time Congress should listen to the slim accountants. The logic behind their thinking is simple:

1) If options aren't a form of compensation, what are they?
2) If compensation isn't an expense, what is it?
3) And if expenses shouldn't go into the calculation of earnings, where in the world should they go?

Stephen Barr, Senior Contributing Editor of CFO Magazine
Letter to the Editor of the New York Times
April 5, 2002:

Re "Leave Options Alone" (Op-Ed, April 5), by John Doerr and Frederick W. Smith: What if, in the mid-1990's, accounting-rule makers had not caved in to lobbyists and instead had forced companies to recognize options as a compensation expense on financial statements?

There would still have been a technology boom, a bear market and a period of recession. Such cycles are immutable. But there may have been less of the accounting gamesmanship that is now the object of government investigation and investor ire.

Options should count as an expense to the corporation, and the ability to exercise them should be based on stock performance that exceeds an index of peers.